No. 15887

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

BELRIDGE OIL COMPANY,

Respondent.

BRIEF FOR THE RESPONDENT.

With Appendices.

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Opinion Below.

The opinion and findings of the Tax Court of the United States in the case below [R. 79-104] are reported in 27 T. C. 1044.

Jurisdiction.

The Petition for Review was taken pursuant to the provisions of Section 7483 of the *Internal Revenue Code of 1954,* and jurisdiction is conferred on the Court by Section 7482 of the 1954 Code.

The proceeding involves Federal internal revenue taxes, for the taxable year ended December 31, 1950, in the form of corporate income and excess profits taxes under the provisions of Chapter 1 of the *Internal Revenue Code of 1939.* The respondent was and is a California cor-

poration with its principal office in Los Angeles, California, and it filed its income and excess profits tax return for the year 1950 with the internal revenue office in and for the Los Angeles, California, district [R. 38], which office and district is located within the jurisdiction of the United States Court of Appeals for the Ninth Circuit.

On May 28, 1954, the Commissioner of Internal Revenue mailed to the respondent the statutory notice of determination of deficiencies in income tax ($33,879.44) and excess profits tax ($9,866.88) for the taxable year 1950 [R. 38]. On August 18, 1954 (a date within ninety days of the mailing of the deficiency determinations), the respondent filed a petition in the Tax Court of the United States seeking a redetermination of the asserted tax deficiencies [R. 3, 5-20]. Jurisdiction of said petition was conferred in the Tax Court by Section 6213(a) of the *Internal Revenue Code of 1954* (which continued, substantially unchanged, the provisions of Sec. 272(a) of the 1939 Code). On July 26, 1957, the Tax Court entered its decision that a deficiency in income tax, for the year 1950, in the amount of $1,246.97, existed against the respondent [R. 112].

The case is brought to this Court by a Petition for Review, filed by the Commissioner of Internal Revenue on October 18, 1957 [R. 113-117] pursuant to the provisions of Sections 7482 and 7483 of the *Internal Revenue Code of 1954.*

Questions Presented.

Did the Tax Court of the United States grant to the respondent a greater allowance for the depletion of oil and gas wells than it is entitled to under Sections 23(m) and 114(b)(3) of the *Internal Revenue Code of 1939?*

Statutes and Regulations Involved.

The pertinent statutes and regulations involved are reproduced, in material part, in the Appendix A, *infra*.

Sections of the Internal Revenue Code of 1939, referred to herein, are reported in Title 26, U. S. C. A., Internal Revenue Code of 1939, as amended; and sections of the Internal Revenue Code of 1954 are reported in Title 26, U. S. C. A., Internal Revenue Code.

The sections of the United States Treasury Department Regulations 111, referred to herein, are reported in 26 C. F. R., 1949 Edition.

Statement of the Case.

With respect to oil and gas properties, Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939 (App. A, *infra*) and the United States Treasury Department Regulations applicable thereto (Reg. 111, Secs. 29.23(m)-1, 29.23(m)-2 and 29.23(m)-4, App. A, *infra*) provide, in substance, that in computing taxable net income, a taxpayer who owns an economic interest in a mineral deposit shall be allowed an annual deduction for a reasonable allowance for the depletion of the oil and gas "property." The Code and Regulations provide that the allowable deduction for depletion shall be computed on the basis of percentage depletion or cost depletion, whichever of the two methods results in the greater deduction; and that the computation shall be made separately for each oil and gas "property." "Percentage depletion" is an amount equal to 27½% of the gross income from the "property" during the taxable year, but "percentage depletion" for any one year cannot exceed 50% of the net income of the taxpayer (computed without allowance for depletion) from the "property." "Cost

depletion" is computed as follows: The "number of units remaining" (that is, the number of recoverable barrels of oil, etc., remaining in the ground) is estimated as of the end of the taxable year. The estimated "number of units remaining" is divided into the adjusted cost (or other adjusted basis for computing gain) of the mineral property, and this gives the "depletion unit" expressed in terms of money. The depletion unit, so determined, is multiplied by the number of units of mineral *sold* (not the number of units produced) during the taxable year, and the result is the amount of "cost depletion" allowable.

The above-cited provisions of the 1939 Code and the applicable Treasury regulations (1939 Code, Secs. 114(b)(3), 23(m); Reg. 111, Secs. 29.33(m)-4, 29.23 (m)-1, 29.23(m)-2; App. A, *infra*) provide that "in no case" shall the allowable depletion deduction be less than the amount of cost depletion, which means that in the case of each mineral "property" the allowable deduction for depletion is *always* the greater of either cost depletion or percentage depletion. This fundamental point is one of considerable importance in the determination of this proceeding.

Prior to and during the tax year 1950 (the year at issue), the respondent, Belridge Oil Company, was the owner of two oil and gas "properties" in Kern County, California, which are referred to in the proceedings below and will be referred to herein, as the "Main Property" and the "Result Property." The Main Property (consisting of 30,845.96 acres) was acquired in 1911, and it encompasses portions of two separate oil and gas producing fields, the North Belridge Field and the South Belridge Field. Production from the North Belridge Field is obtained from five separate zones or pools, one

of which is a relatively shallow zone, and the other four are at the approximate depths of 6,000, 7,000, 8,000 and 9,000 feet, respectively. The zone or pool at the 8,000-foot depth is called the 64 Zone; and the zone or pool at the 6,000-foot depth is called the Temblor Zone. The respondent's Result Property (consisting of 80 acres) was acquired as of September 1, 1944, and it encompasses portions of the 64 Zone and the Temblor Zone of the North Belridge Field.

In addition to underlying portions of the respondent's Main and Result properties, the 64 Zone of the North Belridge field underlies portions of properties owned or leased by five other oil companies. Prior to October of 1941, production by the respondent and the other five oil companies from the 64 Zone was on a competitive basis, which resulted in a marked decrease in reservoir pressure and overall oil production. From October, 1941, to April 1, 1947, a voluntary gas pressure maintenance program was put into effect by the six companies, and a portion of the gas produced from the 64 Zone was returned to the Zone to maintain reservoir pressure. However, in April of 1947, the six companies producing from the 64 Zone abandoned their program of voluntary pressure maintenance, and resumed unrestricted competitive production, which continued up to February 1, 1950.

As of February 1, 1950, the respondent and the five other oil companies producing from the 64 Zone entered into an agreement (entitled "Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California") for the production of oil and gas on a cooperaitve basis "to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of the Participants." (Four extra copies

of the Unit Agreement [Tax Court Ex. 3-C] have been lodged with the Clerk of the Court; and, in the interests of economy, the agreement will not be reproduced in this brief.)

In the Unit Agreement, the respondent was named as the "Operator"; and each of the six parties to the agreement, as an owner of a right to develop, operate and produce in the 64 Zone, transferred the exclusive possession of its "operating rights" to the respondent, as Operator, with the stated intention "to establish Operator as its agent under this agreement, for the sole purpose of developing, operating, and protecting its interest in the 64 Zone to the extent herein set forth." Under the Unit Agreement each of the Participants was alloted a "participating equity," expressed in terms of a percentage, of the oil, etc., produced and saved from the 64 Zone by the Operator; and each Participant took its share of the production in kind. The respondent's participating equity was 71.87%, and this participation, as well as the participations of the other five parties, approximated the same percentages of total production from the 64 Zone which the several parties had achieved during the period of unrestricted competitive production which had continued from April of 1947 to the effective date of the Unit Agreement, February 1, 1950.

In prior years and up to and including the month of January of the year at issue (1950), both the respondent and the Commissioner of Internal Revenue had consistently treated the Main Property (inclusive of the North and South Belridge fields and of the five zones of the North Belridge Field, to the extent such fields and zones were under the Main Property) as one mineral "property" for depletion deduction purposes. This procedure

is authorized by United States Treasury Department Regulations 111, Section 29.23(m)-1(i) (App. A., *infra*), and see also *Island Creek Coal Company* (1958), 30 T. C. ......, No. 35. Similarly, in prior years and up to and including the month of January of the year at issue, both the respondent and the Commissioner had consistently treated the Result Property (including the 64 Zone and the Temblor Zone underlying it) as one mineral "property," and as a property separate from the respondent's Main Property, for depletion deduction purposes.

On its 1950 tax return, the respondent computed and claimed separate depletion deductions for its Main and Result Properties. As in past years, the respondent regarded the 64 Zone underlying its Main Property as being part of the Main Property; and the respondent regarded the 64 Zone underlying its Result Property as being part of its Result Property. The depletion deduction claimed with respect to Main Property was based on percentage depletion, which was greater than cost depletion, since the respondent had fully recovered its cost of the Main Property in prior years. The depletion deduction claimed with respect to the Result Property was based on cost depletion, which was greater than percentage depletion, in the case of the Result Property.

As the basis of his determination of tax deficiencies for the year 1950, the Commissioner conceded that, for the month of January, 1950, the respondent's Main Property (inclusive of the 64 Zone) was a separate property for depletion purposes, with respect to which percentage depletion was allowable; and that, for the month of January, the respondent's Result Property (inclusive of the 64 Zone) was a separate property for depletion purposes,

with respect to which cost depletion was allowable. However, for the eleven-month period in 1950 after the effective date of the Unit Agreement (February 1, 1950), the Commissioner claimed that the respondent had three separate and altered properties for depletion purposes, on the theory that, as of the effective date of the Unit Agreement, the respondent severed the 64 Zone portions of its Main and Result properties from the remainder of said mineral properties, and then, within the meaning of Sections 112(b)(1) and 113(a)(6) of the 1939 Code (App. A, *infra*), it made a tax-free exchange of the two severed 64 Zone portions for a new and separate depletable property in the form of a 71.87% share of the oil, etc., produced by itself as Operator under the Unit Agreement. The effect of the Commissioner's severance and tax-free exchange theory is as follows:

Month of January, 1950:

Respondent had two separate depletable properties:

No. 1. The Main Property, inclusive of the 64 Zone and the other four zones underlying the property.

No. 2. The Result Property, inclusive of the 64 Zone and the Temblor Zone underlying it.

February to December, 1950:

Respondent had three separate depletable properties:

No. 1. The Main Property, excluding the 64 Zone but including the other four zones underlying it.

No. 2. The Result Property, excluding the 64 Zone, but including the Temblor Zone underlying it.

No. 3. A new depletable property consisting of 71.87% of the production from the 64 Zone under the Unit Agreement.

The results of the Commissioner's theory and determination were deficiencies in income and excess profits taxes for the year 1950, arising from the following procedures and adjustments:

1. For the month of January, 1950, the Commissioner recognized that the 64 Zone underlying the Main Property was part of said property for the purpose of computing the allowable percentage depletion deduction.

2. For the month of January, 1950, the Commissioner recognized that the 64 Zone underlying the Result Property was part of said property for the purpose of computing the allowable cost depletion deduction.

3. For the eleven-month period February to December, 1950, the Commissioner disallowed the cost depletion deduction which the respondent had claimed with respect to its Result Property.

4. For said eleven-month period, the Commissioner reduced in amount the percentage depletion deduction which the respondent had claimed with respect to its Main Property.

5. For said eleven-month period the Commissioner computed and allowed a deduction for percentage depletion (limited to 50% of the net income, computed without depletion, from the property) with respect to the respondent's 71.87% share of production under the Unit Agreement.

6. Although required by the statute and his regulations, the Commissioner *made no attempt to compute cost depletion* applicable to the respondent's 71.87% share of production under the Unit Agreement.

The Tax Court of the United States rejected the Commissioner's determination that the respondent, as of the date of the Unit Agreement (February 1, 1950), effected a severance and tax-free exchange of the 64 Zones underlying its Main and Result properties for a new and separately depletable property in the form of respondent's 71.87% of the oil, etc., produced and saved by it, as Operator, under the Unit Agreement. And the Tax Court agreed with the respondent that, both before and after the effective date of the Unit Agreement, the respondent was possessed of two separate depletable mineral properties; namely, its Main Property, inclusive of the 64 Zone underlying it, and its Result Property, inclusive of the 64 Zone underlying it. The Tax Court revised the respondent's computation of the allowable depletion [R. 104-112] and (based on miscellaneous adjustments made by the Commissioner in his deficiency notice which are not at issue in this case) the Tax Court determined that there is a deficiency in income tax for the year 1950 in the amount of $1,246.97 [R. 112]. The respondent accepts said determination of income tax deficiency, and it has paid the deficiency, together with interest thereon.

The Tax Court determined (1) that the Unit Agreement contains no words of conveyance or exchange of depletable interests; (2) that there was no intention on the part of the parties to the Unit Agreement to convey or exchange their interests in the 64 Zone; and (3) that the net effect of the Unit Agreement was nothing more

than a joint effort on the part of the owners of the producing rights in the 64 Zone to best conserve their respective individual interests by joining in a plan for the most economical and productive operation of the Zone; and that each Participant had the same essential rights and interests in its respective property after the Unit Agreement as before, except that, by mutual consent, they had agreed to limit their production, and to operate their wells in the most economically feasible way, from the standpoint of conservation considerations [R. 79-104].

The Commissioner, in his Petition for Review [R. 113, 115-116], *concedes* the Tax Court determinations which are labeled (1) and (2) in the preceding paragraph. That is, the Commissioner concedes, in his Petition for Review, that the Unit Agreement contains "no words of conveyance" of the 64 Zone properties, and that "there was no expressed intention on the part of the participants to convey or exchange their economic interest in the Zone" [R. 115-116].

The Commissioner contended, in his Petition for Review, that the "practical consequence of the transaction . . . was the same as though formal contracts of exchange had been executed," and he stated the issue presented for review as follows:

> "Whether the Tax Court erroneously held that by joining in a unitization agreement for the cooperative operation of all the wells in a certain oil pool, taxpayer did not *exchange* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest . . ." [R. 115-116; italics supplied.]

However, in his Brief for the Petitioner, the Commissioner now states he is *abandoning* the "exchange" theory

ARGUMENT.

I.

The Petitioner Has Abandoned the Theory Upon Which the Case Was Pleaded, Tried, and Decided in the Tax Court, and the Petitioner's New Theory on Appeal Would Require Determinations of Fact, With Respect to Which No Evidence Was Adduced in the Trial Court; Therefore, the New Theory Should Not Be Considered on Appeal.

In its opinion, the Tax Court stated the main issue for decision as follows [R. 81; italics supplied]:

> "(1) Whether, by joining in a unitization agreement for the co-operative operation of all wells in a certain oil pool, petitioner *exchanged* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under unitized operation; . . ."

And in his Petition for Review, the petitioner stated the issue as follows [R. 115; italics supplied]:

> "The issue to be presented for review therefore is: Whether the Tax Court erroneously held that by joining in a unitization agreement for the co-operative operation of all the wells in a certain oil pool, taxpayer did not *exchange* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under the unitized operation and is, accordingly, entitled to claim percentage depletion on one and cost depletion on the other as previously claimed by taxpayer."

The petitioner now states in his Brief that it is abandoning the "exchange" theory for a contention that there was

a "merger" of interests; and petitioner expresses concern "(l)est taxpayer conceive our abandonment of the 'exchange' theory and our present argument as a new argument . . ." (Pet. Br. pp. 16-17, footnote 5). The respondent certainly does conceive and contend that the Commissioner has abandoned on appeal the only theory upon which the case was pleaded, tried, briefed, and decided in the Tax Court; and that the petitioner's new "merger" theory is an entirely new theory of the case which cannot properly be raised on appeal, particularly since the implementation of the new theory would require determinations of fact, with respect to which no evidence was adduced in the Tax Court.

> *General Utilities & Operating Company v. Helvering* (1935), 296 U. S. 200, 56 S. Ct. 185, 80 L. Ed. 154;
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> *Union Pacific Railroad Company v. Johnson* (9 Cir., 1957), 249 F. 2d 674;
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> *United States v. Marshall* (9 Cir., 1956), 230 F. 2d 183, 193;
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> *Inman-Poulsen Lumber Company v. Commissioner* (9 Cir., 1955), 219 F. 2d 159;
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> *United States v. Merrill* (9 Cir., 1954), 211 F. 2d 297;
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> *United States v. Waechter* (9 Cir., 1952), 195 F. 2d 963;
>
> *Bagnall v. Commissioner* (9 Cir., 1938), 96 F. 2d 956;
>
> *Kottemann v. Commissioner* (9 Cir., 1936), 81 F. 2d 621.

And see also:

> *American Bemberg Corporation v. United States of America* (3 Cir., 1958), 253 F. 2d 691.

In the *General Utilities* case, *supra,* the Supreme Court determined that a point not presented to or ruled upon by the Board of Tax Appeals, and not stated in the petition for review, was not a proper subject for consideration by the appellate court; and the Supreme Court *reversed* the decision of the Court of Appeals for the Fourth Circuit which was based on the new theory. The Supreme Court said (296 U. S. at 206, 80 L. Ed. at 157):

> "Always a taxpayer is entitled to know with fair certainty the basis of the claim against him. Stipulations concerning facts and any other evidence properly are accommodated to issues adequately raised."

The language of your Honorable Court in the *Union Pacific* case, *supra,* is in a similar tone (249 F. 2d at 677):

> "One of the things that ought to be certain is that parties do not find themselves trying a new and different case on each successive higher branch of the appellate tree. If this rule is observed, plaintiff and defendants in the end will profit from the certainty of the law."

See also your decision in the case of *Kottemann, supra* (81 F. 2d at 622-623):

> "We are first concerned with the question of whether or not petitioner is barred in this court from raising this question, not having brought the *precise point* to the attention of the Board of Tax Appeals." (Italics supplied.)

And the Court went on to hold that:

> "It is a fundamental rule of federal appellate procedure that only such points as are made in the court below or such questions as are there raised will be reviewed on appeal; and unless the questions or points have been presented to the court below, they are not before this court for review."

The respondent has emphasized the language in the *Kottemann* case, *supra,* that the *"precise point"* must be brought to the attention of trial court, if it is to be availed of on review; and a similar ruling was made by your Honorable Court in the *Bagnall* case, *supra* (96 F. 2d at 958), where the Court pointed out that it is not enough that the disputed point "lurked in the record" below, since the appellate court may not "consider or determine any point not *pressed* before the Board of Tax Appeals or ruled upon by that body." (Italics supplied.)

A. The Record Clearly Shows That Petitioner Has Abandoned the Theory of the Case, and Is Improperly Advancing a New Theory on Appeal.

Appendix B of this brief contains an exhaustive analysis of the record, complete with citations and quotations, which demonstrates beyond point of cavil that the petitioner's announced "abandonment of the 'exchange' theory" is an unauthorized and unfair abandonment of the theory upon which the deficiency determination was asserted, and the case was pleaded, tried, and decided in the Tax Court. And in the light of the above-cited decisions of the Supreme Court and your Honorable Court, the petitioner's new "merger" theory is not a proper subject of appellate review in this proceeding.

B. The Petitioner's New "Merger" Theory Would Require Substantial Factual and Legal Elaboration, Not Grounded on the Record, to Sustain It; and, for That Reason Alone, Cannot Properly Be Introduced Into This Case as a New Matter on Appeal.

The statement made in the headnote to this division of respondent's brief is amply supported by the decision of your Honorable Court in *Bagnall v. Commissioner* (9 Cir., 1938), 96 F. 2d 956, and by the recent decision of

the Third Circuit in *American Bemberg Corporation v. United States of America* (3 Cir., 1958), 253 F. 2d 691. And the petitioner's new "merger" theory, like Pandora, opens the lid on a host of troublesome problems, both legal and factual, which cannot be decided on the basis of the existing record.

Petitioner states he is abandoning the "exchange" theory, yet he contends that by some process (the precise characterization of which he claims is unnecessary) the respondent acquired a new, separate, and single depletable interest in return for its former two property interests in the 64 Zone. Certainly if this is what took place (as the petitioner asserts), it must have had tax consequences, for under Section 111 of the 1939 Code the following general rules are stated (italics supplied):

> "(a) The gain from the sale or *other disposition* of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> "(b) The amount realized from the sale or *other disposition* of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Although the petitioner claims that under his new "merger" theory the "(p)recise characterization of the nature of the unitization transaction as to this taxpayer is unnecessary," it is safe to assume it was not a "sale" and petitioner has expressly abandoned the contention that it was a tax-free "exchange"; therefore, the transaction, under petitioner's new theory, must fall in the *"other disposition"* category of Code Section 111, necessitating

the computation of a gain or a loss for the year at issue. In order to compute either gain or loss on the petitioner's new theory, the Court would have to know at least two things, *neither of which appears in the record:* namely, the adjusted basis of the two properties the respondent is supposed to have disposed of, and the fair market value of the new property allegedly received in return. At the trial of this case, the petitioner sought to qualify a valuation expert (Engineer Revenue Agent Roger F. White), but the witness never did place a monetary value either on the 64 Zone portion of the Result Property [the Result Property encompasses a portion of the Temblor Zone as well as a portion of the 64 Zone, R. 44-45], nor on the alleged new interest in the unitized operation [R. 68-78]. And there is nothing in the stipulation of facts covering the foregoing matters [R. 38-51], although the parties did stipulate, in effect, that the respondent had no tax basis for its Main Property 64 Zone interest [R. 43, par. 17].

We next come to another insoluble problem presented by the petitioner's new "merger" theory: What is the amount of the tax basis of the alleged new separate and single depletable unit which the respondent is supposed to have acquired? Section 113(a) of the 1939 Code states the general rule that:

> "The basis of property shall be the cost of such property . . ."

One of the exceptions to the general rule occurs in the case of tax-free exchanges (Sec. 113(a)(6) of the 1939 Code, App. A, *infra*); but since the petitioner has repudiated the "exchange" theory, the cited exception is not applicable under petitioner's new theory, and the general cost-basis rule would govern. Under the cases and the

regulations (*Estate of Myers* (1942), 1 T. C. 100 (Acq.); *MacCallum Gauge Company* (1935), 32 B. T. A. 544 (Acq.); Title 26 C. F. R., Part 1, Sec. 1.1012-1), the *cost* of the alleged new property acquired under the petitioner's "merger" theory would be the *fair market values* (not the adjusted tax bases) of the respondent's original interests in the 64 Zone; and the record in this case is totally devoid of any factual basis for making the necessary determination of the cost basis of the alleged new property interest.

Under the revenue codes it would be mandatory to determine the cost basis of the alleged new property interest for, as previously pointed out in this brief, Sections 114(b)(3) and 23(m) of the Code, and Sections 29.23(m)-4, 29.23(m)-1, and 29.23(m)-2 of Treasury Regulations 111 (App. A, *infra*) are specific on the point that "in no case" shall the allowance for depletion be less than the allowance based on the unit, or, cost, basis; and one obviously needs to know what the cost basis is before the necessary unit, or cost, computation can be made. See *Producers Oil Corporation* (1940), 43 B. T. A. 9, at 11, where the Board held as follows (italics supplied):

> ". . . under the last clause of section 114(b)(3) the allowance under the percentage method may in no case be less than under the unit method. To one using the percentage method a computation by the unit method is *always necessary,* for *'in no case shall'* the allowance be less than such a computation shows. *This is mandatory.*"

Any attempt to compute the mandatory unit, or cost, depletion on the alleged new property interests would engender additional legal and factual frustrations. To illustrate, the unit, or cost, depletion computation contemplated by Treasury Regulations 111, Section 29.23(m)-2 (App. A, *infra*) can be expressed by the formula: $D = \frac{C}{R} \times P$, where "D" stands for the allowable cost depletion deduction; "C" stands for the adjusted cost basis; "R" stands for the estimated total number of units (barrels of oil, etc.) in the ground at the end of the year; and "P" stands for the number of production units which are taken into account.

Respondent has previously demonstrated that the record contains no basis for determining factor "C" in the above formula, under the petitioner's new theory; but neither is there any basis in the record for determining factor "R." With respect to factor "P," the parties have stipulated that, under the Unit Agreement, 237,062 barrels of oil were actually produced from wells located on the *surface areas* of the respondent's Main and Result properties, and that respondent was allocated 307,704 barrels of unit production [R. 46, pars. 22, 23]. Which of these figures (237,062 or 307,704) should be used as factor "P" in the formula and why? This problem was not presented to nor passed upon by the Tax Court, and since the petitioner, on brief, is extremely critical of the sound and reasonable solution which the Tax Court arrived at in an analogous situation (see Pet. Br. pp. 19-20), it would

be interesting to know what course he advocates (and on what grounds) now that he is brought to the realization that he is faced with the same problem under his new theory on appeal. But the petitioner's brief is silent on this vital point.

Respondent could go on and multiply instances in which the petitioner's new "merger" theory would create factual and legal problems, insoluble on the basis of the existing record, but enough has been written to demonstrate the complete applicability of the salutary principle announced by your Honorable Court in an analogous case (*Bagnall v. Commissioner* (9 Cir., 1938), 96 F. 2d 956, at 958), wherein the Court stated the following:

> "Once we undertake to construe and apply the trust instrument, numerous and perplexing collateral questions, some of law, others of fact, intrude themselves and demand answer—questions not ruled upon by the Board, not presented by the assignments, and discussed, if at all, only in belated and inadequate briefs . . . In reviewing orders of the Board made on petitions to redetermine assessments of deficiencies we are dealing with intricate and difficult problems inherent in the administration of a great department of the government, as well as with equally intricate provisions of the revenue laws themselves. This case illustrates as well as any the good sense of the rule which confines the courts to a review of the points presented to or ruled on by the administrative tribunal clothed by Congress with full authority to inquire into and determine disputes, both as to the law and as to the facts."

II.

In Essence, This Appeal Is From the "Decision" (as Distinguished From the "Opinion") of the Tax Court. That Decision Is That There Is a Deficiency in Income Tax in the Amount of $1,246.-97; and Since the Petitioner Cannot, on the Record, Show a Greater Amount of Tax Liability, the Decision of the Tax Court Must Be Affirmed.

In the preceding division of this brief the respondent has demonstrated the salutary principle that, on appeal, the decision of the trial court cannot be reversed on a theory different from the one on which the case was tried and decided. However, the appellee, and the appellate court, is *not* limited by this rule in seeking to *uphold* the decision of the trial court. That is, on an appeal from the Tax Court, the prevailing party below is entitled to the benefit of every inference which reasonably can be drawn from the evidence, viewed in the light most favorable to him and most unfavorable to the appellant, and if the *decision* of the Tax Court is correct, it must be affirmed, even though the lower court relied upon a wrong ground or gave a wrong reason.

> *Helvering v. Gowran* (1938), 302 U. S. 238, 58 S. Ct. 154, 82 L. Ed. 224;
>
> *United Pacific Railroad Company v. Johnson* (9 Cir., 1957), 249 F. 2d 674 (footnote 4 on p. 677);
>
> *Card v. Commissioner* (8 Cir., 1954), 216 F. 2d 93, at 96-97;
>
> *Wheeler v. Holland* (5 Cir., 1955), 218 F. 2d 482;
>
> *Gulf, Mobile & Ohio R. Co. v. Williamson* (8 Cir., 1950), 191 F. 2d 887, at 893.

Under the applicable statute (Sec. 7482 of the *Internal Revenue Code of 1954*) your Honorable Court is granted jurisdiction to review the *decision* of the Tax Court. The decision in this case is [R. 112]:

> "That there is a deficiency in income tax for the taxable year 1950 in the amount of $1,246.97."

The word "deficiency" is defined by law to mean "(t)he amount by which the tax imposed by this chapter exceeds the amount shown as the tax by the taxpayer upon his return (Sec. 271, *Internal Revenue Code of 1939,* and see Sec. 6211, 1954 Code). In other words, "a deficiency consists, not of a theory or a method of computation, but of a sum of money representing the difference between what the taxpayer's return discloses and what the law in fact imposes on him under the actual circumstances." (*Veeder v. Commissioner* (7 Cir., 1927), 36 F. 2d 342.)

It is, therefore, elemental that the petitioner here cannot show that the *decision* of the Tax Court is wrong unless he can affirmatively demonstrate what he considers to be the correct amount of the tax for the year at issue. And petitioner cannot do this, either under his new "merger" theory or under his abandoned "exchange" theory, because there is absent from the record the required factual basis for making the necessary computation or computations.

Enough has been said in division I-B of this brief to demonstrate that the petitioner has not made a record sufficient to support *any* tax computation under his new "merger" theory—he cannot show whether gain or loss (much less the amount of gain or loss) was realized on the alleged disposition of the old 64 Zone interests for a new interest; he cannot compute cost depletion under his new theory, although the statute makes mandatory such a computation, etc.

With respect to the petitioner's abandoned "exchange" theory, the record similarly is barren of a factual foundation to support a tax computation on the basis asserted by the petitioner. Respondent has previously demonstrated that the statute, the regulations, and the case decisions all make mandatory the computation of depletion on a cost basis, since "in no case" shall the allowance for depletion be less than depletion computed on the basis of cost (Secs. 114(b)(3) and 23(m) of the 1939 Code; Reg. 111, Secs. 29.23(m)-4; *Producers Oil Corporation* (1940), 43 B. T. A. 9, at 11). Despite this statutory requirement, the petitioner originally made his determination of deficiency without regard to cost depletion, and the Tax Court so found as a fact [R. 96]:

> "No computation of cost depletion with respect to that 71.87 per cent undivided interest appears in the deficiency notice."

In an effort to overcome this obvious defect, petitioner called Engineer Revenue Agent White as a witness at the trial [R. 68-78], but the witness gave no testimony that would support a finding concerning cost basis under the petitioner's now-abandoned "exchange" theory, and the Tax Court made no such finding. Nor was any evidence adduced or finding made concerning the number of units (barrels of oil, etc.) in the reserve, under the petitioner's abandoned "exchange" theory (see Reg. 111, Sec. 29.23 (m)-2, App. A, *infra*); and a cost depletion computation cannot be made without this figure being established.

An additional reason why the petitioner is required to demonstrate a proper computation of cost, or unit, depletion in this proceeding is that the Tax Court determined, in effect, that there was *no* excess profits tax deficiency in this case [R. 112, 104-111], yet the petitioner's State-

ment of Points to Be Relied Upon advances, as a basis for review, the claim that the Tax Court erred [R. 120]:

> "12. In failing to hold and decide that there is . . . a deficiency in excess profits tax of $9,866.88."

(This is the amount of the excess profits tax deficiency originally asserted by the petitioner.) Yet in order to make the necessary determination of invested capital, for excess profits tax computations, the allowable depletion deduction must be computed on the cost, or unit, basis, as distinguished from the percentage depletion basis (*Internal Revenue Code of 1939,* Secs. 435-441, Title 26 U. S. C. A. Excess Profits Taxes; Vol. 1 *Merten's, Law of Federal Income Taxation* (Zimet, Stanley & Kilcallen Revision) Sec. 9.33). For example, the last cited work states the following (Ch. 9, pp. 53-54):

> ". . . it is important to keep in mind that earnings and profits must be determined for two different purposes—dividend source for income tax computation and invested capital for excess profits tax computation . . . In computing total earnings and profits for the purpose of determining invested capital, depreciation and depletion must be computed on cost or other basis without regard to March 1, 1913 value. . . .
>
> "Thus, discovery or percentage depletion as otherwise allowable for income tax purposes to operators of mines, and oil and gas wells and the like, is not to be taken into account in computing earnings and profits."

The respondent submits that since the petitioner cannot make a proper tax computation on *any* theory, heretofore

advanced or now advanced by him in this proceeding, he cannot demonstrate that the *decision* of the Tax Court is in error. And since, on appeal, all intendments must be indulged in in favor of the correctness of that decision, it is respectfully submitted that your Honorable Court is required to affirm the decision of the Tax Court.

III.

The Tax Court Correctly Determined That the Respondent Retained the Same Interests and Rights in Its Two Separate 64 Zone Properties After Unitization as Before; and That Neither in Form nor in Substance Were the Pre-existing Rights Exchanged or Otherwise Disposed of for a New Depletable Interest.

The Tax Court stated that, in order to uphold the Commissioner's deficiency determination:

> "We must find that the unitization agreement here, preferably both in form and in substance, effected an exchange; and, if not in form, certainly in substance." [R. 99.]

And the Tax Court held that nowhere in the unitization agreement [Ex. 3-C] "do we find any words of conveyance; and, more important, we find no intention on the part of the Participants to convey or exchange their economic interests in the 64 Zone" [R. 100]. The Petition for Review *concedes these points* and confesses:

> ". . . there are no words of conveyance in the agreement involved . . . and there was no expressed intention on the part of the participants to convey or exchange their economic interests in the Zone . . ." [R. 115-116.]

Now, however, some eight and one-half years after the Unit Agreement went into effect, the petitioner asks your Honorable Court:

(a) to disregard the form of the transaction;

(b) to disregard the intentions of the Participants;

(c) to disregard petitioner's own theory on which the deficiency was determined, the case tried, and the Petition for Review filed;

(d) to disregard as "irrelevant" the premises upon which the Tax Court based its decision;

and to determine for the first time that the substance of the transaction was something of a different nature, although petitioner refuses to be tied down to specifics, under claim that "(p)recise characterization of the nature of the unitization transaction as to this taxpayer is unnecessary" (Pet. Op. Br. 16-17). It is respectfully submitted that to accede to the petitioner's request would discredit accepted principles of fair tax administration and proper trial and appellate procedures.

The Tax Court's determination that neither the form nor the substance of the Unit Agreement [Ex. 3-C] effected a change in depletable interests was based on sound grounds. The absence of words or forms of conveyance in the Unit Agreement is, in itself, a factor of importance, for in the case of *Usibelli v. Commissioner* (9 Cir., 1955), 229 F. 2d 539, at 543, your Honorable Court emphasized the contractual relation factor as follows:

> "The question whether any given taxpayer engaged in the extractive industries has, under the facts of his particular case, a depletable interest in the mineral in place, is difficult and depends for its answer upon the various incidents of the contractual relation under which he works."

The Unit Agreement [Tax Court Ex. 3-C] is concerned with the rights of the Participants "to develop and operate in and produce from the 64 Zone oil, gas and associated hydrocarbons" [Ex. 3-C, Art. II, Sec. 1]. Article V of the Agreement is entitled "Transfer of Operating Rights and Other Property," and the reference to "Other Property" is to *depreciable* tangible property, the transfer of which is not an issue in this case. (See *Choate v. Commissioner* (1945), 324 U. S. 1, 65 S. Ct. 469, 89 L. Ed. 653.) In regard to "operating rights," the only "transfer" effected was made in the following language [Art. V, Sec. 1, Ex. 3-C]:

> "At the effective time of this agreement Operator shall take *exclusive possession* of the operating rights of each Participant in and to the 64 Zone and enter into the performance of its duties hereunder; subject, however, to the right of each Participant to use and occupy its lands within the Area pursuant to Section 3 of Article II." (Italics supplied.)

All that the Operator got, under this provision, was "exclusive possession" of the operating rights to the extent necessary for it to perform its duties as Operator; and it is material to note that, even in this instance, the possession of the rights by the Operator was as *agent* for the several Participants, in that Section 3 of Article XIII of the Unit Agreement provides as follows:

> "It is the intention of each Participant to establish Operator as its agent under this agreement, for the sole purpose of developing, operating and protecting its interest in the 64 Zone to the extent herein set forth."

Further in this regard, while the Operator is designated as the "agent" of each Participant, we have in this case

the circumstance that Belridge was both a Participant and the Operator. Under the law of agency a person cannot be the agent for himself, and certainly there is no contrary rule in tax law—a corporation cannot engage in tax-significant transactions with itself. It follows, therefore, that even if the taking of "exclusive possession of the operating rights" by the Operator, as agent, could be considered the transfer of a depletable interest (which respondent denies), there could not be a recognizable transfer of depletable interests between the respondent, as a Participant, and itself, as Operator-agent for itself. Incidentally, the circumstance that Belridge was designated and acted as Operator was not fortuitous nor was it subject to change without its consent. The respondent, as the largest producer in the Zone, and the holder of a 71.87% Participating Equity under the Agreement, was a natural and logical choice as Operator; and since the Agreement requires the vote of at least 80% of the Participating Equities to effect the removal of the Operator and the selection of a successor Operator (Art. III, Secs. 1 and 3(a)), the consent of the respondent would be required, since it controls 71.87% of the necessary votes.

The fact that the Participants had no intention of divesting themselves of their mineral interests in the 64 Zone, or otherwise, is further evidenced by the provision of Article XI of the Agreement [Ex. 3-C], which provides that each Participant shall retain the right at any time or from time to time, to sell, assign, transfer, quitclaim, surrender, or otherwise dispose of its interests, or any thereof, in or to the lands covered by the Agreement, including the 64 Zone. And the only limitation on this retained right of transfer or surrender is the limitation, common to any well drafted operating agreement, that no

transfer or surrender of an interest in lands, with respect to the 64 Zone, shall be made separate from a corresponding interest in Unit Wells and Unit Facilities, and no such transfer or surrender shall be made under such circumstances that the interests in the 64 Zone shall not remain subject to the Unit Agreement.

The retention by each Participant of all rights in the 64 Zone included the very "operating rights" which were entrusted to the "exclusive possession" of the Operator [Art. XI of Ex. 3-C], and each Participant reserved the right to sell, assign, transfer, quitclaim, surrender, or otherwise dispose of the operating rights, subject to the Agreement. This fact appears from not only the broad retention of rights stated in Article XI of the Agreement, but from the definition of "Participant" [Art. I, Sec. 1(e) of Ex. 3-C], which reads as follows (italics supplied):

> "Participant shall mean an owner at the date of this agreement, *and each successor, assignee or transferee of such owner, of the right to develop and operate lands within the Area and to produce Unitized Substances,* whether as lessor or otherwise . . ."

The respondent submits that there is nothing in the form or substance of the Unit Agreement that remotely resembles a transfer of a mineral property interest in the 64 Zone, much less the reciprocal exchange of like mineral property interests, which the Court must find in order to sustain the Commissioner under the theory on which the deficiency was determined and the case was tried, argued, decided, and appealed. The word "exchange," as used in the internal revenue acts and codes, means:

> ". . . a mutual grant of equal interests, the one in consideration of the other. 'Exchange' is a word of precise import, meaning the giving of one thing for

> another, requiring the transfers to be in kind." (*Trenton Cotton Oil Co. v. Commissioner* (6 Cir., 1945), 147 F. 2d 33, at 36.)

Or, as expressed in the petitioner's regulations (Reg. 111, Sec. 29.112(a)-1):

> "To constitute an exchange within the meaning of section 112(b)(1) . . . the transaction must be a reciprocal transfer of property . . ."

All that was intended, and effected, by the Unit Agreement was to entrust a single Operator (acting as the agent and in the interest of each individual Participant) with the task of developing, operating, and producing from the 64 Zone, to the end that the Zone might be operated economically as an engineering unit for conservation purposes, and thus avoid the unreasonable waste of oil, gas, and reservoir pressure that had occurred during the periods of unrestricted competitive production which preceded the effective date of the Unit Agreement.

The Tax Court could find "no intention on the part of the Participants to convey or exchange their economic interests in the 64 Zone" [R. 100], and the petitioner concedes, in the Petition for Review [R. 116] that "there was no expressed intention on the part of the participants to convey or exchange their economic interests in the Zone." In the case of *Gowans v. Commissioner* (9 Cir., 1957), 246 F. 2d 448, at 451, your Honorable Court emphasized the importance of the intent, or purpose, factor as follows:

> "It has been held that where the predominating purpose of the agreement is the economic exploitation of the deposits, this is indicative of a retained economic interest. . . . It would seem to follow that

> where some other purpose predominates, the opposite conclusion concerning retention of economic interest would be invited."

In the matter at issue, the Tax Court determined the *purpose* of the respondent, and the other unit Participants, to be as follows [R. 100-101]:

> "The purpose which prompted the execution of the agreement in question was the recognition on the part of the Participants that unrestricted competitive production from the Zone was causing a lowering of the gas pressure and would eventually result in possible serious underground waste of oil, gas, and associated hydrocarbon products. For a period of some 5½ years prior to April 1, 1947, the participants had maintained a voluntary gas pressure program. . . . We think the unitization agreement here was nothing more than another joint effort on the part of the owners of the producing rights to the Zone to best conserve their respective individual interests therein by joining in a plan for the most economical and productive operation of the whole field. Hence, we think each Participant had exactly the same interests and rights in its respective properties after unitization as before, except that by mutual consent they had agreed to limit their production and operate their wells in the most economical feasible way from the standpoint of conservation requirements."

For another, and excellent, statement of this same theme, see "Tax Problems in Unitization," by John E. Kilgore, Jr., 1957 *Tulane Tax Institute* 1, at page 17:

> "As stated above, the principal result of unitization is to modify the effect of the Rule of Capture and to realize, to some degree, the condition in which the owner of a surface tract embracing part of a reser-

voir can recover that part of the oil underlying his tract. To that extent, *the creation of a unit is the creation of a mechanism for realizing the value of property rights, and not a mechanism for exchanging old property rights for new ones.*" (Italics supplied.)

The applicable cases involving unit agreements, as well as considerations of national oil and gas conservation policy, completely support the Tax Court's determinations. *Phillips Petroleum Company v. Petersen* (10 Cir., 1954), 218 F. 2d 926, certiorari denied 349 U. S. 947, was not a tax case, but since the decision involves an excellent and exhaustive analysis of the substance of unitization agreements, including their necessity as a matter of national conservation policy, it has an obvious pertinence to the case at issue.

The *Phillips* case involved the validity of the unitization clause contained in some thirty-one oil and gas leases, which Phillips had obtained from Utah landowners. "Section 12" of each lease gave Phillips, as the lessee, the right to unitize, pool, or combine the subject property with other lands in the same general area by entering into a cooperative or unit plan of development or operation, in which event the lease shall be deemed modified to conform to the terms of the unit agreement; and the section also provided that unit production allocated to land under the unit agreement shall be regarded as having been produced from the land for the purpose of paying royalties under the lease. Under Section 12 the lessor agreed to give formal approval to the unit agreement by executing it at the request of the lessee.

Phillips had entered into a unit agreement for the Roosevelt Unit area in Utah, and included in the unitized area were state public lands and Indian lands, as well as

privately owned lands. Thirty-one of the lessors refused to sign the unit agreement, and Phillips brought action in the Federal District Court against them seeking declaratory judgments that Section 12 of the lease was valid and binding upon the lessors. The trial court found that Section 12 was invalid and unenforceable on the ground, among others, that no valid exercise of the power given by Section 12 could be made because of the rule against perpetuities. The appellate court stated the issue involved as follows (218 F. 2d at 930):

> "Section 12 does not violate the rule against perpetuities, unless the unitization or pooling agreement accomplishes transfers of interests in real property, or, otherwise stated, effects cross-transfers of property interests among the parties to the agreement."

The Court held that no cross-transfers of property interests were effected by unitization; hence the lease clause did not violate the rule against perpetuities.

In the course of its opinion in the *Phillips* case, *supra,* the Court quoted the following language from Section 12 of the leases:

> ". . . In the event that said above-described lands or any part thereof, shall hereafter be operated under any such cooperative or unit plan of development or operation whereby the production therefrom is allocated to different portions of the land covered by said plan, then the production allocated to any particular tract of land shall, for the purpose of computing the royalties to be paid hereunder to lessor, be regarded as having been produced from the particular tract of land to which it is allocated and not to any other tract of land; and the royalty payments to be made hereunder to lessor shall be based upon production only as so allocated . . ." (218 F. 2d at 930.)

The Court interpreted this provision to mean in substance that "the effect of unitization was to be only with respect to allocation of production and the computation of royalties, and was not to effect cross-transfers of royalty interest" (218 F. 2d at 930). The Court (referring to the language of the unit agreement, as distinguished from the leases) further stated the following (218 F. 2d at 931):

> "Moreover, an intent that there shall be no cross-transfers of royalty interests may be derived from a provision that proportions of the unit production shall be allocated to the respective tracts and that the portion so allocated to each tract shall be treated as if it had actually been produced from such tract. By such an allocation method of participation in unit production the parties clearly demonstrate their intention that the royalty and working interest ownership within each tract immediately prior to unitization shall continue in effect, since the static ownership within the respective tracts comprising the unit is the basis and the only basis upon which the allocation method of participation functions."

[The Unit Agreement at issue in this appeal [Ex. 3-C] likewise provides for the allocation of unit production on the basis of the static ownership within the respective tracts involved in the Unit; see Art I, Sec. 1(e) to (h); Art. II, Sec. 1; Art. IV, Sec. 7; Art V, Sec. 1; Art. VII, Secs. 1, 3, and 4; Art X, Sec. 1; Art. XI; Art. XIII, Secs. 3 and 4; and Ex. E, which is part of Trial Ex. 3-C.]

The Court in the *Phillips* case, *supra,* stated that the unit agreement it was considering "clearly provided" that cross-transfers of property interest were *not* to be effected by

unitization, by virtue of the following provisions [which find their counterparts in the portions of Ex. 3-C, cited in the preceding paragraph]:

> ". . . Nothing herein, however, shall be construed to transfer title to any land or to any lease or operating agreement, it being understood that under this agreement the Unit Operator, in its capacity as Unit Operator, shall exercise the rights of possession and use vested in the parties hereto only for the purposes herein specified.
>
> ". . . All unitized substances produced from each participating area established under this agreement . . . shall, . . . be deemed to be produced equally on an acreage basis from the several tracts of unitized land of the participating area . . . and, for the purpose of determining any benefits accruing under this agreement, . . . each tract of unitized land shall have allocated to it such percentage of said production as the number of acres in such tract bears to the total acres of unitized land in said participating area . . ." (218 F. 2d at 930-931.)

The decision in the *Phillips* case, *supra,* devotes several pages to demonstrating the desirability of oil and gas unitization agreements as an instrument of the long-established national policy to conserve and prevent undue waste of vital natural resources (218 F. 2d pp. 931-933). Among other things, the Court stated the following:

> "Provisions in oil and gas leases for unitization have become a practical necessity in the oil and gas industry, because of governmental rules and regulations imposing strict requirements for the proper spacing of wells and the granting of production allowables on the basis of formulae predicated in whole or in part on the quantity of acreage from which the

> oil and gas can be efficiently recovered by one well completed in the reservoir involved. Permeability, porosity, and other information relating to the producing zone can be scientifically analyzed and a reasonably accurate determination made of the area from which the oil can be efficiently recovered by a well in that zone for the purpose of fixing the appropriate size of the pooled units for developing such zone. See Hoffman, Voluntary Pooling and Unitization, pp. 87, 88. Moreover, limiting the number of wells to be drilled to those that will efficiently recover the oil and the elimination of the drilling of unnecessary wells will prevent underground waste and the loss of oil which would result if unnecessary wells were drilled." (218 F. 2d 931-932.)

The Court traces some of the history of various Congressional acts authorizing and promoting unitization of federally controlled mineral lands (beginning with the *Act of July 3, 1930, 46 Stat. 1007; 30 U. S. C. A., Sec. 184 and Section 226*), and referred to the efforts of the Department of the Interior to promote and standardize unitization; and the Court stated the following (218 F. 2d at 933):

> "Thus, it will be seen that unitization is a conservation measure which benefits both lessor and lessee and tends to prevent waste of a natural resource.
>
> "The practice of unitization by a power granted the lessee in advance, if faithfully carried out, will be fair and profitable both to the lessor and lessee, and is vital to the oil and gas industry in the interests of the conservation of both natural and material resources. It should be upheld . . ."

It is submitted that the interpretation of the unit agreement by the Court in the *Phillips* case, *supra,* constitutes a controlling precedent in the interpretation of similar language contained in the Unit Agreement at issue. It is further respectfully submitted that the concern, evidenced by the Court in the *Phillips* case, to avoid a decision that might impede the usefulness of unitization as a measure to conserve vital natural resources, should find like expression in the deliberations of your Honorable Court. That is, the continued use of unitization as a tool for the conservation of natural resources should not be impeded by the danger that a "booby trap" in the nature of perilous changes in depletion allowances may be attached. Tax uncertainty might well bring an end to a constructive program of conservation that is part of our policy as a nation. Some appreciation of the intense Federal interest in oil and gas unitization as an instrument of Federal conservation policy can be obtained from the 1955 address of J. Revel Armstrong, Solicitor of the Department of the Interior, published in *First Annual Rocky Mountain Mineral Law Institute* (Mathew Bender & Company, 1955) pages 45-57. Further, it was a requirement of California law (*Public Resources Code of the State of California,* Sec. 3301) that, before the Unit Agreement at issue could become effective, there had to be a determination by the State Oil and Gas Supervisor that it is in the interest of the protection of oil and gas from unreasonable waste that the Agreement be entered into. This determination was made by the Supervisor and he expressly approved the Agreement [Ex. 3-C, p. 45]. Thus, the Agreement at issue is entitled to solicitous consideration by the Court as an instrument of State, as well as national, conservation policies.

The case of *Campbell, Jr. v. Fields* (5 Cir., 1956), 229 F. 2d 197 (affirming D. C. Texas; unofficial report 55-1 U. S. T. C. par. 9318) was an income tax case involving the question whether expenditures for surveying charges and attorneys' fees paid in connection with the unitization of gas leases, to comply with the Texas law relating to pooling and unitization, were deductible as business expenses "incurred in order that taxpayers might realize and enjoy income" (229 F. 2d 197, at 203), or were they capital expenditures incurred in the "modification of the leases resulting in their conversion into unitized proration units calculated to increase their capital value" (229 F. 2d 197, at 201).

The facts in *Campbell, Jr. v. Fields* were that the Texas Railroad Commission issued an order restricting the drilling of gas wells, in the Waskon Field, to one well for each 640-acre unit. Taxpayers (husband and wife) incurred the expenses in forming five proration units—in three of them they owned all of the leases, but in the other two units, the taxpayers combined their leases with leases owned by G. Corporation and S. Corporation, in order to make up two proration units of approximately 640 acres each. A "Pooling and Operating Agreement" was executed by the taxpayers and G. Corporation, with respect to one unit, and a similar agreement was executed by the taxpayers and S. Corporation, with respect to the other unit. Agreements between the owners of royalty interests and the lessees, approving proration and unitization, were prepared and executed. The taxpayers claimed the expenses as deductions in their joint return for 1948, and upon disallowance, paid the deficiency and sued for refund, which the District Court and the Appellate Court granted.

The Court said that the Government's approach to the problem "gives too much consideration to form and too little to substance" (229 F. 2d at 201) and that it was necessary to "examine the nature of the property right as was evidenced by the leases and the extent to which that right was changed by the pooling and unitization" (229 F. 2d at 201). The Court then stated its analysis of the basic nature of the transaction as follows (229 F. 2d at 201-202):

> "Prior to the formation of a proration unit each participant had the right to a share in the gas in the field to be produced through wells on the land owned by or leased to him even though some part of it may have migrated from the lands of others. These rights were correlative, each owner or lessee of land embracing the field having the right to the oil and gas therein subject to like rights of the others. The enjoyment of these rights was limited by the requirement of well spacing imposed by the State of Texas in the exercise of its police power. The well spacing requirement made pooling and unitization necessary in order to preserve and protect the rights of the taxpayers to their proportionate share of the gas in the field. The pocling and unitization here involved covered only the gas rights. Subsequent to the pooling and unitization each owner and lessee has the right to a share in the gas in the field to be produced through wells on the land included in the unit, each participant's portion being measured by the area of his contribution to the unit. *His ultimate economic interest is little, if any, different after pooling and unitization than before.*
>
> "It cannot be said as a matter of law, and we doubt that there could be any accurate determination as a matter of fact, whether the ultimate realization

by taxpayers would be greater or less with unitization than without well spacing and unitization. *We do not find that the unitization of the leases resulted in any such conversion of the character of taxpayers' investment as worked a basic change in the nature of the property right which they held.*" (Italics supplied.)

The Court further stated (229 F. 2d at 203) that:

"Here the controverted deductions were not made for acquiring property or defending title to property, nor for the purpose of converting one kind of property into some different kind of property. Here the expenses were incurred in order that the taxpayers might realize and enjoy the income from the property."

The decision in *Campbell v. Fields, supra,* necessarily involved the determination that, in substance, no exchange of mineral interests is involved in the unitization of the operating rights incident to oil and gas lease working interests, and, as such, the decision is a precise precedent for upholding the Tax Court's determination in this case.

In his brief, the petitioner erroneously regards common ownership of depreciable equipment [Art. VII, Sec. 2 of Ex. 3-C] as being indicative of a common economic interest in a new producing "property." This approach is but a rehash of an "elaborate argument" previously rejected by the United States Supreme Court. In the case of *Choate v. Commissioner* (1945), 324 U. S. 1, 65 S. Ct. 469, 89 L. Ed. 653, the facts were that the Choate and Hogan partnership owned an oil and gas lease on which were six producing wells and a variety of *depreciable* property (well equipment, casing, piping, pumps, tanks, etc.). The partnership "sold" all its right,

title and interest in the lease and the depreciable property to S. Co. for cash; but expressly *reserved and retained* an overriding royalty of one-eighth of all oil, gas and casinghead gas produced and saved. The taxpayer reported the transaction as a sale. The Tax Court held that while there was an absolute sale of the *depreciable* equipment, the reservation or retention of an interest in production meant that no sale of the lease had taken place. The Tax Court stated the following (italics supplied):

> "Where a royalty interest is *retained,* as was the case here, the principle of recovery by depletion rather than by treatment as a sale applies to all receipts, including any cash bonus which is regarded as in the nature of advance royalties." (*Hogan, et al.* (1942), 1 T. C. M. 208 at 211.)

The Commissioner objected to the Tax Court ruling that a sale of the depreciable equipment had taken place; and before the Supreme Court the Commissioner made what the Court termed an "elaborate argument," on the assumption that "after the partnership transferred its interest in the lease its investment was no longer in the leasehold and equipment as such but was an economic interest in an oil-producing enterprise—an interest which is depletable since it is measured by the production of oil." The Supreme Court was not impressed by this argument, and upheld the Tax Court's determination that while the partnership had sold the equipment, it had retained its economic interest in the lease since it retained a right to share in production from the leasehold.

In the Tax Court case of *Whitwell* (1957), 28 T. C. 372 (now on appeal by taxpayer to the Fifth Circuit), compulsory unitization under the Louisiana statute was involved, and the unitization order directed that the tax-

payer be compensated for the actual costs, expended by him, prior to unitization, to develop the unitized wells, which amounted to $48,000, in round figures. The unitization order directed that this payment be made out of 80% of the unit production from the "particular participating area" in which the unitized wells were situated. Taxpayer reported no part of the sum as taxable income, but the Commissioner determined a tax deficiency on the basis that the sum was depletable income "from the operation of income producing property in which you owned and/or retained an economic interest." On appeal to the Tax Court, taxpayer argued that he had "exchanged" his wells for an interest in the unit, and in the process had received the $48,000 as "boot" money on the exchange, giving rise to capital gain on a taxable exchange. The Commissioner argued before the Tax Court that a "tax-free exchange" had taken place, and that the $48,000 was not received as "boot" money, but as ordinary depletable income.

The Tax Court said:

> "We do not think it was necessary for the (Commissioner) to argue that there was a nontaxable exchange of interests here in order to sustain his determination that the oil payments constituted ordinary income to the petitioners subject to depletion";

and the Court held that since there was no doubt the taxpayer had an economic interest, the payment to them out of the proceeds of oil production was depletable income, just as the Commissioner's deficiency notice had determined.

In the course of its opinion in the *Whitwell* case, *supra,* the Tax Court cited with approval its own opinion in the Belridge case; and stated that said opinion was a

complete answer to the "exchange" theory advanced by both parties in the *Whitwell* case. The Tax Court said:

> ". . . unitization amounts to no more than a production and marketing arrangement as between owners of oil producing property or rights.
>
> ". . . No interests were assigned or exchanged. There was merely an allocation of the production of oil from the pool beneath their several properties based on both acreage and development costs."

For some undisclosed reason, the petitioner contends on brief that the *Whitwell* case, *supra,* amounts to a recognition by the Tax Court "that a new depletable interest can be created by virtue of a unitization agreement" (Pet. Op. Br. 20-21). Petitioner does not elaborate on this bald statement, which seems manifestly unsound. The opinion in the *Whitwell* case discloses that the sum in dispute was payable from a specified portion (80%) of the production "from the particular participating area" in which the taxpayer's unitized wells were located; that the Commissioner's deficiency determination was on the basis that taxpayer "owned and/or retained" an economic interest in the property from which the production payment was made, and that said payment constituted depletable income; and the Tax Court upheld this determination. In other words, the essence of the *Whitwell* opinion and decision was that the taxpayer retained his original mineral interests despite unitization, and that the production payment was depletable income derived from the properties in which he *retained* his interests. Neither the deficiency determination nor the Tax Court's holding made any mention of a new depletable interest, despite the petitioner's unsupported statement to the contrary.

The respondent's misconception of the *Whitwell* case, *supra,* highlights the fundamental error of theory and analysis which permeates his brief. For example, on pages 17-18 of his brief, the respondent makes the following erroneous statement (italics supplied):

> ". . . the execution of an oil and gas lease by a landowner for a lump sum consideration and future payments from production amounting to a royalty interest, as in *Burnet v. Harmel,* 287 U. S. 103, *creates a new depletable interest* (*the royalty interest*) even though, as the Supreme Court expressly held in the *Harmel* case, the transaction is not a sale or exchange of property."

Burnet v. Harmel does not stand for the proposition for which it is cited, and the Commissioner is completely in error in contending that a landowner "creates a new depletable interest" for himself by virtue of a leasing transaction. *The correct view is that the landowner retains or reserves the economic interest he already had if he reserves any continued interest in production,* and that is why the leasing transaction is not regarded as a sale, exchange, or other disposition of the landowner's economic interest. (*Burnet v. Harmel* (1932), 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199; *Palmer v. Bender* (1933), 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489; *Thomas v. Perkins* (1937), 301 U. S. 655, 57 S. Ct. 911, 81 L. Ed. 1324; *Burton-Sutton Oil Company v. Commissioner* (1946), 328 U. S. 25, 68 S. Ct. 861, 90 L. Ed. 1062; *Commissioner v. Southwest Exploration Company* (1956), 350 U. S. 308, 76 S. Ct. 395, 100 L. Ed. 347; *Gowans v. Commissioner* (9 Cir., 1957), 246 F. 2d 448; *G. C. M. 22730,* 1941-1 C. B. 214; *G. C. M. 27322,* 1952-2 C. B. 62.) *G. C. M. 22730, supra,*

states the correct and applicable principle as follows (1941-1 C. B. at p. 216):

> ". . . the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation . . . So considered, the view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, sublessee, or assignee acquires a capital interest upon the execution or assignment of a lease, presents no logical difficulties as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him . . . The lessor does not sell an interest to the lessee. Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property."

See also the statements of your Honorable Court in the *Gowans* case, *supra* (italics supplied):

> "In a series of decisions beginning with *Palmer v. Bender,* 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489, the principle has been developed that an arrangement involving the extraction and removal of nat-

ural deposits from the land of another, is to be deemed a 'sale' only if, at the time such arrangement is entered into, *the owner has alienated all interest therein.* Stated conversely, if an economic interest in the deposits *has been retained,* the transaction is not regarded as a 'sale' for tax purposes." (246 F. 2d at 450.)

"An economic interest *has been retained* where the owner has: (1) acquired, by investment, any interest in the natural deposit in place; and (2) secured by any legal relationship income derived from the extraction of the natural deposit to which he must look for a return of his capital." (246 F. 2d at 451.)

The respondent knows of no case which supports the petitioner's claim that a leasing, etc., transaction "creates" a new depletable interest in an owner who already had the entire depletable interest, and the cases cited in the petitioner's brief are directly to the contrary. And since the petitioner is so completely in error in his analysis of the leasing transaction, it is understandable that he would misconstrue the substance and effects of a unit agreement, such as the one at issue here. A fee owner of depletable oil and gas property (such as the respondent in this case) by virtue of his fee ownership possesses (among other things) the equivalent of the following elements:

1. The entire landowner, or royalty, interest.

2. The entire working interest, consisting of:

(a) the exclusive right to enter and explore for oil and gas;

(b) the exclusive right to develop, operate and produce oil and gas;

(c) the right to retain or dispose of all production, exclusive of the interest in production encompassed by item 1 above;

(d) the obligation to bear the expenses of the exploitation, development, operation, production, etc., activities.

Under the principles announced by the cases and rulings, the land owner can lease or transfer the *entire working interest* (items 2(a) to 2(d) above), and still is not regarded, for tax purposes, as having made a sale, exchange, or other disposition of his or its depletable economic interest, *as long as the landowner retains a right to share in production* (that is, *retains* all or part of the interest designated as item 1, above). In the present case, the respondent, by virtue of the Unit Agreement [Ex. 3-C], simply "transferred" to itself, as Operator, the "exclusive possession" of "operating rights" (the equivalent of items 2(a) and 2(b) above), *retaining* to itself the right to *all* production applicable to its interest (that is, it retained to itself the equivadent of the sum of the production applicable to both the landowner's interest and the working interest). It is obvious from this analysis that, under the principles announced by the cited Supreme Court cases and your decision in *Gowans v. Commissioner, supra,* the Unit Agreement did not and could not, in substance result in any change in the nature or the amount of the repondent's depletable economic interests in the 64 Zone mineral property underlying its Main and Result properties. And the Tax Court was right in holding that under the Unit Agreement in this case, "each Participant had exactly the same interests and rights in its respective properties after unitization as be-

fore, except that by mutual consent they had agreed to limit their production and operate their wells in the most economically feasible way from the standpoint of conservation considerations" [R. 101].

IV.

The Petitioner Errs in His Conception of the Rationale of the Depletion Deduction and the Mechanics of Computing It.

On pages 19 and 20 of his brief, petitioner is critical of the method prescribed by the Tax Court for computing cost depletion on the Result Property. The petitioner terms it "unrealistic," and contends that if the petitioner's theory of separate economic interest is adopted then, according to petitioner, "the very nature and separateness of taxpayer's unitized interest affords a simple and much more realistic basis for computing taxpayer's depletion deduction with respect to 64 Zone oil."

The absurdity of the petitioner's pretention is made evident from these facts:

(a) Petitioner is criticizing the Tax Court because it used, in the depletion computation, the number of barrels of unit production allotted to the Result Property (11,859 barrels), although actual production from wells located on the surface area of the Result Property totalled 21,672 barrels.

(b) Yet, if we accept the petitioner's view that the respondent's unitized 64 Zone interests are a separate property, we have the situation that the number of barrels of unit production allotted to the alleged separate property totalled 307,704 barrels, although actual production from wells on the surface area of the alleged separate property totalled 237,062 barrels [R. 46, Stip. pars. 22, 23].

How is the computation of depletion made "simple and much more realistic" under the petitioner's separate property theory, in the light of the above stipulated facts? (The preceding rhetorical question is posed without consideration of the additional important fact that the record is devoid of evidence concerning the cost basis and the oil reserves of the alleged separate property, so that a depletion computation could not be made in any event under the petitioner's theory.)

The respondent submits that the solution to the problem is in fact simple, and that the Tax Court found and adopted the simple and realistic solution. The key to the answer is this: Under the statute and the regulations, percentage depletion and cost depletion computations have to be correlated and compared in order to determine which gives the greater depletion allowance. It logically follows that the computations have to be made on a comparable basis, and *that basis is the number of units* (*barrels, etc.) sold,* not the number of units produced. This is obvious in the case of the percentage depletion computation—since percentage depletion is based on gross receipts, you consider only the number of barrels sold, for only those are productive of gross receipts. The point may be less obvious in the case of the cost depletion computation, since many persons (and some court opinions) loosely speak of cost depletion in terms of "production"; yet the applicable regulations (Reg. 111, Sec. 29.23(m)-2, App. A, *infra*) plainly states that in computing cost depletion the depletion unit (obtained by dividing the reserve into the dollar amount of the adjusted cost basis) shall be multiplied by:

> "the number of units of mineral *sold* within the taxable year." (Italics supplied.)

The plain fact that cost depletion is *not* geared to production, but that it *is* geared to gross receipts, is made evident by the definition, in the cited regulation, of "units sold" in the case of a cash basis taxpayer. The definition is as follows (Reg. 111, Sec. 29.23(m)-2, App. A, *infra*):

> "As used in this section the phrase 'number of units sold within the taxable year,' in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year."

Once we accustom our thinking to the fact that both the percentage depletion computation and the cost depletion computation must be in terms of units sold, not units produced, then the solution of the unitized production problem is simple, for in each case you look to the number of units *allotted* to the participant, for that is the number of units he can and does sell. He can't sell what he doesn't get and is not entitled to, even though it may have been produced from wells located on the surface area of his property subject to the unit agreement.

In this case, the Tax Court correctly computed percentage and cost depletion in terms of the number of units sold, not the number of units produced [R. 103-104, 104-111]. And since the estimated number of units in the underground reserve is subject to periodical *prospective* revision, at the instance of either the Commissioner or the taxpayer, there is no ground for concern that the reserve will become unbalanced or exhausted prior to the recovery of cost (Reg. 111, Sec. 29.23(m)-9, App. A, *infra;* and see *Ah Pah Redwood Company v. Commissioner* (9 Cir., 1957), 251 F. 2d 163.)

Conclusion.

The decision of the Tax Court of the United States is in accordance with the law and its findings are not clearly erroneous; therefore, the decision should be affirmed.

Respectfully submitted,

John B. Milliken,

Harrison Harkins,

Counsel for Respondent.

June 20, 1958.

APPENDIX A.

Statutes and Regulations Involved.

Statutes.

Internal Revenue Code of 1939, Section 23 (m). (26 U. S. C. A. (I. R. C. 1939) Sec. 23 (m))

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the

pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

Internal Revenue Code of 1939, Section 114 (b) (1) and (3). (26 U. S. C. A. (I. R. C. 1939) Secs. 114 (b) (1) and (3))

Sec. 114. Basis for Depreciation and Depletion

* * * * * * * *

(b) Basis for Depletion.—

(1) General Rule.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * * * * *

(3) Percentage Depletion For Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

Internal Revenue Code of 1939, Section 113 (a) (6) (26 U. S. C. A. (I. R. C. 1939) Sec. 113 (a) (6))

Sec. 113. Adjusted Basis For Determining Gain or Loss.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * * * * * * *

(6) Tax-Free Exchanges Generally.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, or section 112 (1), the basis * * * shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) or section 112 (1) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. Where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this paragraph, be considered as money re-

ceived by the taxpayer upon the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

Internal Revenue Code of 1939, Section 113 (b) (1) (B) & (C) (26 U. S. C. A. (I. R. C. 1939) Sec. 113 (b) (1) (B) & (C))

Sec. 113. Adjusted Basis For Determining Gain or Loss.

* * * * * * * *

(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made.

* * * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(i) allowed as deductions in computing net income under this chapter or prior income tax laws, and

(ii) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this chapter (other than subchapter E), subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this chapter of prior income tax laws. Clause (ii) of this subparagraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under subsection (d). Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

Internal Revenue Code of 1939, Section 112 (b) (1) (26 U. S. C. A. (I. R. C. 1939) Sec. 112 (b) (1))

Sec. 112. Recognition of Gain or Loss.

* * * * * * * *

(b) Exchanges Solely In Kind.—

(1) Property Held For Productive Use Or Investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

United States Treasury Department Regulations.

(Promulgated under the Internal Revenue Code of 1939) Reg. 111, Section 29.23 (m)-1 (26 C. F. R., 1949 Edition, Sec. 29.23(m-1). Depletion of Mines, Oil and Gas Wells, Other Natural Deposits and Timber; Depreciation of Improvements.—

Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed with respect to any timber which the owner has disposed of under any form of contract by virtue of which the owner retains an economic interest in such timber; if such disposal is considered a sale of the timber under section 117(k)(2) of the Code. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between

the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

*   *   *   *   *   *   *   *

When used in these sections (29.23(m)-1 to 29.23 (m)-28, inclusive) covering depletion and depreciation—

(a) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(b) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term "mineral deposit" refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

*   *   *   *   *   *   *   *

(f) The term "gross income from the property", as used in sections 114(b)(3) and 114(b)(4)(A) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the following:

In the case of oil and gas wells, "gross income from the property" as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If

the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * * * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property."

* * * * * * * *

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114(b)(2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the "gross income from the property" as defined in paragraph (f) of this section less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (f) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. * * * If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in

paragraph (f) shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(h) "Crude mineral product," as used in paragraph (f) of this section, means the product in form in which it emerges from the mine or well.

(i) "The property," as used in section 114(b)(2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate "property"; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single "property," provided such treatment is consistently followed.

Reg. 111, Section 29.23(m)-2 (26 C. F. R., 1949 Edition, Sec. 29.23(m)-2). Computation of Depletion of Mines, Oil and Gas Wells, and Other Natural Deposits, Without Reference to Discovery Value or Percentage Depletion.—

The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in section 113(a), adjusted as provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property. (See sections 29.113(a)-1 to 29.114-1, inclusive.) If the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by

multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

As used in this section the phrase "number of units sold within the taxable year," in the case of a taxpayer reporting income on the cash receipts and disbursements basis, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year. The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

"The number of units of mineral remaining as of the taxable year" is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the "number of units sold within the taxable year" as defined in this section.

In determining the amount of the basis as adjusted applicable to the mineral deposit there shall be excluded (a) amounts representing the cost or value of the land for purposes other than mineral production (b) the amount recoverable through depreciation and through deductions other than depletion, and (c) the residual value of other property at the end of operations, but there shall be included, in the case of oil and gas wells, those amounts of capitalized drilling and development costs which, as provided in section 29.23(m)-16, are recoverable through depletion.

In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy, the taxpayer may compute the depletion allowance (without reference to percentage depletion) in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in closed or rock pressure during the taxable year and the denominator of which is equal to the expected total decline in closed or rock pressure from the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodic pressure determinations.

Reg. 111, Section 29.23(m)-4. (26 C. F. R., 1949 Edition, Sec. 29.23(m)-4) Computation of Depletion Based on a Percentage of Income in Case of Oil and Gas Wells.—

Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see section 29.23 (m)-1 (f) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost of other basis of the property provided in section 113.

Reg. 111, Section 29.23(m)-7 (26 C. F. R., 1949 Edition, Sec. 29.23(m)-7) Determination of Fair Market Value of Mineral Properties, Including Oil and Gas Properties.—

(a) If the fair market value of the property at a specified date is to be determined for the purpose of ascertaining the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight, (1) if the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the pres-

ence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer or to extrinsic causes other than the possession of the mineral itself. If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

* * * * * * * *

(d) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property should be valued separately.

* * * * * * * *

(e) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date as of which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the depreciable assets and of the capital additions, if any, necessary to realize the profits.

* * * * * * * *

(f) If, for the purpose of the equitable apportionment of depletion among the several owners of economic interests, the value of any mineral property must be ascertained as of any specific date for the

determination of the basis for depletion, the values of the several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral property in fee simple.

Reg. 111, Section 29.23(m)-8 (26 C. F. R., 1949 Edition, Sec. 29.23(m-8). Revaluation of Mineral Deposits Not Allowed.—

No revaluation of a property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved.

* * * * * * * *

The value should be redistributed—

(a) If a revision of the number of remaining recoverable units of mineral in the property has been made in accordance with section 23(m) and section 29.23(m)-9, and

(b) In the case of the sale of a part of the property, between the part sold and the part retained.

Reg. 111, Sec. 29.23(m)-9. (26 C. F. R., 1949 Edition, Sec. 29.23(m)-9. Determination of Mineral Contents of Mines and of Oil and Gas Wells.—

If it is necessary to estimate or determine with respect to any property as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in the ground as of that date, the estimate or determination must be made

according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion shall include as to both quantity and grade—

(a) The ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms with respect to the type of the deposit, and

(b) "Probable" or "prospective" ores and minerals (in the corresponding sense), that is, ores and minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development; but "probable" or "prospective" ores and minerals may be estimated (1) as to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological or other evidence to a high degree of probability, and (2) as to grade, only as accords with the best indications available as to richness.

If the number of recoverable units of mineral in the property has been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the property as of the taxable year will be the number remaining from the prior estimate, but in any case in which it is ascertained either by one taxpayer

or the Commissioner as the result of operations or development work prior to the close of the taxable year that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised and the annual depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate unless a change in the facts requires another revision. Such revised estimate will not, however, affect the basis for depletion.

Reg. 111, Section 29.112(b)(1)-1 (26 C. F. R., 1949 Edition, Sec. 29.112(b)(1)-1). Property Held for Productive Use in Trade or Business or for Investment.—

As used in section 112(b)(1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm. or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unim-

proved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

A transfer is not within the provisions of section 112(b)(1) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112(c).

Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation.

Reg. 111, Section 29.113(b)(1)-1. (26 C. F. R., 1949 Edition, Sec. 29.113(b)(1)-1.) Adjusted Basis: General Rule.—

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of such property or, in the case of such property as is described in section 113(a)(1) to (22), inclusive, the basis therein provided, adjusted to the extent provided in section 113(b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. In the case of mines and oil or gas wells the following shall not be considered as items properly chargeable to capital account: (1) Expenditures made * * * which are allowable under * * * regulations as deductions in computing net income;

* * * * * * * *

The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect to any

period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under chapter 1 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period.

* * * * * * * *

The deductions by which the cost or other basis is to be decreased shall include deductions allowed under section 114(b) (2), (3), and (4) of the Revenue Act of 1932, the Revenue Act of 1934, the Revenue Act of 1936, the Revenue Act of 1938, and the Internal Revenue Code, for the taxable year 1932 and subsequent taxable years, but the amount of the diminution in respect of depletion for taxable years prior to 1932 shall not exceed a depletion deduction computed without reference to discovery value in the case of mines, or without reference to discovery value or a percentage of income in the case of oil and gas wells.

The cost or other basis shall also be decreased by the exhaustion, wear and tear, obsolescence, amortization, and depletion sustained in respect of any period prior to March 1, 1913.

* * * * * * * *

APPENDIX B.

Demonstration From the Record That the Petitioner Has Abandoned the Theory of the Case, and Is Advancing an Entirely New Theory on Appeal.

An examination of the record in this proceeding clearly demonstrates that the Tax Court and the parties all considered the basic issue to be in terms of the "exchange" theory, which the petitioner has abandoned in this Court; and that the petitioner's new "merger" theory was not pressed before the Tax Court, nor ruled upon by that body. In the first place, the parties stipulated to the admission of *Joint* Exhibit 2-B (the report of the examining officer) "for the purpose of showing the basis used by the respondent (the petitioner in this Court) in determining the deficiency here at issue." [Stip. of Facts, par. 4, R. 38-39, 67, portion in parenthesis supplied in the foregoing quotation.] Item (a) of Schedule 1(a) of Joint Exhibit 2-B states the basis of the depletion adjustment to be "that a *non taxable* exchange transpired and that the basis of the interest received in the Unit is the combined basis of the assets so transferred thereto." (Italics supplied.)

In subparagraph (v) of paragraph V of the taxpayer's Petition to the Tax Court [R. 15], the taxpayer alleged the basis of the Commissioner's determination, and the Commissioner admitted this allegation in his Answer [R. 36]. The language of the admitted allegation is as follows [R. 15]:

> "(v) Over the objections of the petitioner the Commissioner has determined that by virtue of the Unit Agreement, and on its effective date (February 1, 1950), the petitioner made *nontaxable exchanges* of its separate interests in the 64 Zone underlying the

> area covered by the Unit Agreement, for a single and separate depletable interest (consisting of an undivided interest in the amount of 71.87%) in the properties covered by the Unit Agreement, including the petitioner's own portions of the 64 Zone underlying its Main Property and its Result property, and that the basis to the petitioner for said undivided interest is the combined adjusted bases of its separate interests in the 64 Zone underlying the area covered by the Unit Agreement." (Italics supplied.)

The same language as the last quotation was requested by the taxpayer as a finding of fact in its Opening Brief before the Tax Court (page 24, item 30 of said brief), and this requested finding was agreed to by the Commissioner (page 9, item 30, of the Commissioner's Brief in Answer).

Counsel for the taxpayer, in his opening statement before the Tax Court, stated the points at issue [R. 54-56], and counsel for the respondent did not disagree with said statement [R. 57]. The statement of issues was, in material part, as follows [R. 54-56; italics supplied and portions in parenthesis added]:

> ". . . The main issue in this case involves the proper interpretation of this unit agreement document . . . The petitioner (Belridge) claims that the agreement simply provides for the co-operative development and operation of the 64 Zone as a unit, and was not a title passing agreement. The respondent (Commissioner) claims that either the unit agreement or the substance or the results of the unit agreement is that an *exchange* of property interest occurred, and that the petitioner (Belridge) made a *non-taxable exchange* of its 64 Zone property interest for an undivided interest in the unit operation

> of the 64 Zone, and that by reason of that *exchange,* the new interest acquired took a basis—took the adjusted basis of the properties transferred, and it must be treated in the future as a separate property . . .
>
> "Now, if the Court should decide that the unit agreement resulted in an *exchange* of property interest as the respondent (Commissioner) claims, then the deficiency asserted is in order with a matter of adjustment of some one hundred twenty or one hundred thirty dollars. If the Court should decide that the respondent (Commissioner) is wrong in this main issue and that there was no *exchange* of property interest, then there would still remain for a decision a further issue raised by the respondent (Commissioner) as to the proper method of computing cost depletion on the Result Property. He disputes the method claimed on the return."

In his opening statement before the Tax Court, counsel for the Commissioner did use the word "merger," but he used it in the sense that the word conveyed the same meaning as "exchange." For example [R. 64]:

> "The idea of a *merger or exchange,* of course, under the respondent's viewpoint—what took place was a *like for like exchange,* our old friend 112-B-1, not taxable . . ."

(Note: The reference to "112-B-1" was meant as a reference to Section 112(b)(1) of the Internal Revenue Code of 1939 (App. A, *infra*), which provides, in part, that no gain or loss shall be recognized if productive business property is *exchanged* solely for property of a like kind to be held for productive use in business.)

The taxpayer's Opening Brief before the Tax Court stated the principal point in controversy in terms of

whether or not an *exchange* of properties or economic interests had taken place (Op. Br., pp. 2, 3, 6, 33). For example, taxpayer stated the following (Op. Br., p. 2; italics and portions in parenthesis supplied):

> "*The principal point in controversy,* relative to the amount of the depletion deduction allowable in 1950, is whether or not the petitioner (Belridge), on February 1, 1950, *exchanged* the properties or economic interests which it then owned in the 64 Zone (an oil and gas deposit) for a new and separately depletable property interest in the 64 Zone. The respondent (Commissioner) has determined that the *exchange* took place, and that a new depletable property interest in the 64 Zone was acquired; and the petitioner (Belridge) contests this."

Before the Tax Court, the taxpayer's argument was necessarily restricted to refuting the Commissioner's determination that an exchange had taken place (taxpayer's Op. Br., pp. 33-58) since the statutory notice of deficiency determination was issued on that basis, the stipulation of facts had been entered into with that issue in view, and the opening statements of counsel stated the issue in terms of exchange or no-exchange.

It is true that the Commissioner's Brief In Answer before the Tax Court contained, in various places, the words (or their derivatives) *"merge, consolidate, or exchange"* in the disjunctive. For example, see pages 3 and 23. However, the Commissioner consistently stated his argument in terms of the "exchange" theory, as is evidenced by the following excerpts from his Tax Court

Brief In Answer (italics and portions in parenthesis supplied):

(a) Under the heading "Points Relied Upon:"

"Respondent's (the Commissioner's) position is that, in substance, under the unitization agreement petitioner (Belridge) accomplished a severance of Main's 64 Zone and Result's 64 Zone and, on contributing them to the unit *in return for* an undivided 71.87 percent interest in the units production from the entire 64 Zone pool, petitioner obtained a new 'property' for depletion purposes. Since *such exchange* was non-taxable, petitioner's (Belridge) basis in its new unit property was the sum of the adjusted bases remaining to petitioner (Belridge) in the portions of the Main and Result contributed to the unit." (Br. In Ans., pp. 13-14.)

(b) On page 22(a) of the Commissioner's Brief In Answer, he refers to a case then pending before the Tax Court and states that his *"position there as here is that unitization effects an exchange of properties of like kind."*

(c) The Commissioner's main argument in his Tax Court Brief (page 28) bears the heading:

"D. Respondent's determination that the unitization accomplished a *tax-free exchange* of economic interests is consistent with his position of long standing, is in accordance with the authorities, and reflects the substance of the matter."

And under the above-quoted heading the subheadings are:

"(1) The 'like kind' term of Section 112(b)(1) I. R. C. of 1939 is applicable.

"(2) *An exchange was accomplished."* (Br. In Ans., p. 28.)

(d) On pages 32-33 of his Tax Court Brief In Answer, the Commissioner stated:

> "Since petitioner (Belridge) obtained its single, 64 Zone unit interest *by reason of a tax-free, Section 112(b)(1), exchange* of two separate 64 Zone interests, petitioner's basis in its single interest is a transferred basis or the sum of the bases (cost) in what was transferred. Section 114(b)(1) I. R. C. of 1939."

It is abundantly clear that the Tax Court, with complete justification, conceived the question for decision to be in terms of the "exchange" theory on which the Commissioner's deficiency determination was based. The headnote (prepared by the Tax Court) to the Findings of Fact and Opinion of the Tax Court [R. 79-81] stated the following [R. 80-81; italics and portion in parenthesis supplied]:

> "Respondent (Commissioner) determined that the effect of the unitization agreement was a *tax free exchange under section* 112(b)(1) by petitioner (Belridge) of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production . . . Held, petitioner (Belridge) did not *exchange* its interests in its two separate properties for a new depletable interest by participating in the unitization agreement, . . ."

And in the body of its Findings of Fact and Opinion, the Tax Court stated the issues as follows [R. 81-82; italics and portion in parenthesis supplied]:

> "The issues to be decided are: (1) Whether, by forming in a unitization agreement for the co-operative operation of all wells in a certain oil pool, peti-

tioner (Belridge) *exchanged* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under unitized operation; and (2) if not, the amount of the cost depletion allowance which it is entitled to deduct for one of its separate properties covered by the unitization agreement."

At other places in its opinion, the Tax Court described the theory of the case as follows (italics and portions in parenthesis supplied):

"Respondent (the Commissioner) determined that, by virtue of the unitization agreement, petitioner (Belridge) made *nontaxable exchanges* on February 1, 1950, of its two separate interests in the 64 Zone for a single depletable interest therein . . ." [R. 95.]

"The respondent (Commissioner) contends that the effect of the unitization agreement here was a *tax free exchange* by petitioner (Belridge) of its oil producing rights in the 64 Zone pool underlying its Result Property, and that part of its Main Property subject to the agreement, for a new and separate depletable economic interest consisting of and measured by its 71.87 per cent of oil produced under unitized operation of the field. Section 112(b)(1) provides, in substance, that no gain or loss shall be recognized if property held for productive use in a taxpayer's trade or business is *exchanged* solely for property of a like kind to be held for a like purpose. *To uphold the respondent's (the Commissioner's) determination we must find that the unitization agreement here, preferably both in form and in substance, effected an exchange; and if not in form, certainly in substance.*" [R. 98-99.]

"Neither in those provisions of the agreement, nor elsewhere, do we find any words of conveyance; and, more important, we find no intention on the part of the Participants to *convey or exchange* their economic interests in the 64 Zone." [R. 100.]

We come next to the Petition for Review [R. 113-117], in which the Commissioner asked your Honorable Court to review the Tax Court decision. Material excerpts from the Petition are as follows (italics supplied):

(a) "The Commissioner determined that the effect of the unitization agreement was a *tax-free exchange under Section 112(b)(1)* by taxpayer of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production . . ." [R. 114-115.]

(b) "The Tax Court held that taxpayer did not exchange its interest in its two separate properties for a new depletable interest by participating in the unitization agreement . . .

"The issue to be presented for review therefore is: Whether the Tax Court erroneously held that by joining in a unitization agreement for the co-operative operation of all the wells in a certain oil pool, taxpayer did not *exchange* its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under the unitized operation and is, accordingly, entitled to claim percentage depletion on one and cost depletion on the other as previously claimed by taxpayer." [R. 115.]

(c) "It is the position of the Commissioner that the practical consequence of the transaction here, whereby the unitization was accomplished, was ex-

actly the *same as though formal contracts of exchange had been executed* . . . Furthermore, the practical consequence of a unitization agreement is, therefore, that the owner of a larger interest in a small property which has been *exchanged* for a smaller interest in a larger property no longer looks to the production from the well or wells on his original property but does look to all wells on a unitized block." [R. 116.]

The Petition for Review was filed October 18, 1957 [R. 117], and was not accompanied by a statement of points to be relied upon. Subsequently, on December 16, 1957 [R. 120], the petitioner here filed his Statement of Points To Be Relied Upon, which included the following, among the twelve points stated [R. 117-118; italics supplied]:

"That the Tax Court of the United States erred:

"1. In failing to hold and decide that taxpayer, as a participant in the unitization agreement, contributed separate operating interest in the 64 Zone in return for 71-87 T (*sic*) of the unit production and thereby, in substance and effect, *merged, consolidated or exchanged* such separate interests for a new depletable interest consisting of an undivided 71.87% interest in 64 Zone mineral property.

". . .

"4. In holding and deciding that the taxpayer did not *exchange* its interests in its two separate properties for a new depletable interest by participation in the unitization agreement."